

Market split on state backing of Detroit Public Schools ahead of restructuring legislation

By Gunjan Banerji

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Michigan's state backing for schools is under a microscope once again as the municipal market awaits the USD 3.4bn restructuring of Detroit Public Schools (DPS), said market participants.

As the state inches closer to revealing plans for DPS' overhaul, the market has varying degrees of faith in Michigan's commitment to the schools as well as the long-term viability of Governor Rick Snyder (R)'s plan. So far, the governor has proposed splitting up the distressed district into two entities: one with educational assets alongside an injection of new capital, and another with the schools' legacy liabilities.

The legislation was supposed to be released by 31 October, and was postponed to this week, a spokesperson for the governor's office said. Now, it will likely be released the week of 9 November, the spokesperson said.

Changing language incites doubt

Earlier this year, the district made an about-face in the way it addressed the School Bond Qualification and Loan Program (SBQLP) and bankruptcy in offering documents, as reported. Now, in a Michigan Treasury presentation seen by Debtwire Municipals, a footnote states that its USD 1.5bn of long-term qualified debt is a liability with "uncertainty" regarding how it would be ruled upon in a bankruptcy.

This language is concerning, said Tamara Lowin of Belle Haven Investments, regarding the allusion to bankruptcy. Other obligations include USD 464m in short-term notes backed by state aid and the limited tax general obligation pledge of the district, a USD 1.3bn net pension liability with the Michigan Public Employee Retirement System, and USD 195m in loans from the state, according to the presentation.

"It's unclear how creating two districts but keeping the same amount of general obligation debt helps DPS," Lowin said. "I don't see how DPS gets out from under its financial difficulties without reducing the debt burden."

Additionally, DPS' financial and educational health has a domino effect on the city of Detroit's long-term viability, said Patrick O'Keefe, a Michigan-based restructuring expert for a firm with his namesake.

Homebuyers require public safety and thriving public schools—often, the quality of a school system determines home prices in a municipality, which can affect the caliber of commercial development, O'Keefe said.

DPS has ranked last in academic achievement compared to urban districts nationwide, according to the Citizens Research Council. The deteriorating educational quality has spurred an explosion of charters that has further chipped away at the district's balance sheet.

"I'm dubious that the state's proposal addresses the underlying educational quality of the school district, which is required for long-term financial success of both the city and the schools," O'Keefe said.

Paying for yesterday's schools

The state has made various moves to address its most distressed districts, going so far as to dissolve four. In these cases, the property taxes that pay off old district debt must be reauthorized by voters, after the students physically attend the schools.

Governor Snyder's plan is pegged to property values and accompanying taxes. It entails redirecting an 18 millage non-homestead tax to pay off some of the district's debt. However, making good on these obligations will be up to voter renewal in 2022, according to a Citizens Research Council report -- Snyder has stated that his plan will take 10 years, as reported.

The governor's spokesperson stated that such renewals are common in Michigan, but voter outcome in the limited cases of dissolved districts thus far has been split. The dissolved Highland Park and Inkster millages were approved earlier this week, according to local news reports, while Buena Vista voters rejected the non-homestead tax after district dissolution, as reported.

People wondered why an entity was collecting taxes for a school district that was no longer educating students, said Craig Thiel of the Citizens Research Council. It didn't resonate with residents.

"This would be an issue that could be addressed down the line," the governor's spokesperson said regarding the millage approval, adding that the focus is currently on the legislative process and getting a plan in place.

In addition to unknowns with future voting patterns, the schools' revenue for its obligations falls short of its debt service requirements. For the past 10 years, debt service coverage has averaged .79x, according to offering documents.

The district borrows from the Michigan School Loan Revolving Fund (SLRF) to pay debt service on qualified bonds, as reported. DPS' balance with the state has ballooned 75% to almost USD 200m in FY15 from USD 112m in FY13, hogging almost a third of Michigan's cumulative USD 1.7bn SLRF balance.

It's unclear how the district's SLRF balance would be handled in the restructuring.

"Michigan has put itself in a tough spot," said a buy-side analyst.

Glimmers of hope, and yield

But some are bullish on Michigan's guarantee program regardless of the hurdles ahead. The damage Michigan would do to its credit quality as well as to school districts throughout the state hints that Michigan is taking steps to keep its promises to schools and bondholders, said two buy-side analysts.

Governor Snyder has stated that an in-court restructuring would be more costly to Michigan due to the state-shared retirement system and SBQLP. But if the state's promises are money-good, the plan may require more than the USD 715m that Snyder has pledged to save the district down the line, the two said.

The governor's plans appear designed to avoid the need for what some have deemed a bailout, but further state appropriations may be needed down the line if Detroit voters do not approve the local tax renewal before 2022, according to the Citizens Research Council. A presentation to the House Appropriations Subcommittee on School Aid also states that DPS will likely continue to require additional support going forward to address structural liabilities.

If Michigan's backing is solid, then there could be an opportunity to find value in other distressed districts' debt backed by the same guarantee, the first buy-side analyst said. It would be difficult for the state to bail out DPS and leave behind other distressed school districts.

DPS holds an underlying Caa1 rating by Moody's Investors Service and an enhanced Aa1 rating. Standard & Poor's ties an AA-/stable enhanced rating to the district.

DPS did not respond to a request for comment.